Commonwealth of Massachusetts
Before the
Department of Public Utilities

Investigation of the Department of Public Utilities upon its own motion commencing a Notice of Inquiry/Rulemaking, pursuant to 220 C.M.R. §§2.00 et seq., establishing the procedures to be followed in electric industry restructuring by electric companies subject to G.L. c. 164.	)	Docket No. D.P.U. 96-100

INITIAL WRITTEN COMMENTS OF ASSOCIATED INDUSTRIES OF MASSACHUSETTS ON GENERIC ISSUES IN COMPANY RESTRUCTURING PROPOSALS

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I. STATEMENT OF INTEREST

Associated Industries of Massachusetts ("A.I.M.") represents more than 3,600 employers in both the manufacturing and non-manufacturing sectors employing over a half a million people or more in the Commonwealth. A.I.M. was founded in 1915 and has since then sought to advocate the positive public policy decisions to sustain a vibrant and expanding economy, and retain and expand job

opportunities in Massachusetts.

A.I.M. is pleased to provide these initial comments. We stress "initial" because our views like many are evolving as we review in detail the nuances of the plans filed thus far, as we speak to other stakeholders, and as we intellectually process the complex implications of a restructured industry, including the financial implications to utilities and consumers. Over and above the analysis function we are mindful of the legitimate exigencies which effect this process and which must be understood.

A.I.M. has focused on the cost of electricity in the past two years because it is an important business issue. Electricity is a cost factor everywhere that one U. S. Senator, J. Bennett Johnston, said recently "...has profound economic consequences. Lower electricity prices mean more jobs, more economic impact, and more personal income. States with the lowest electricity prices are the most likely to attract new businesses and jobs." Over the past twelve years, our state has lost 225,000 jobs in manufacturing (a 33.5% drop since 1984). Our industrial electricity rates on average is 60% above the industrial average for industrial states. This situation is intolerable. Implicitly the Department recognized this situation when it called on parties to seek rate relief as an over riding goal of restructuring.

The negative effects of such disparities affect everyone and have profound implications for businesses and job creation in Massachusetts. Over the past twenty years and accelerating in the past five years, the national and global marketplaces have required Massachusetts employers to focus on all costs in order to compete effectively, to grow their businesses, and to maintain current employment levels. Our members are supportive of "choice" since it represents a hands-on method to achieve competitive economics through the control of electricity costs.

A.I.M. cannot emphasize too strongly that we view this submission as an opportunity to further

meaningful discussion with affected parties and not as an event disengaging us from substantive discussion (public and private) in the future. In this regard, we will accelerate such opportunities in light of the generic rulemaking phase starting in a few weeks. Within this context, A.I.M.'s underlying concern remains the same: it is the cost of doing business in Massachusetts that seriously compromises the competitive position of Massachusetts employers and employees vis-à-vis the fierce national and global marketplace.

Our initial comments are in two areas. First, what will the electricity world look like at the end of the process and will it sustain robust competition among parties to deliver efficiencies, innovation, and lower costs. Our views in this regard are grouped under the heading market structure. Second, what has to be done between now and when a competitive market is established. We have grouped our comments in this regard under the heading transition.

II. MARKET STRUCTURE

The goal at the end of this process should be a full and fair competitive electricity market where all consumers can purchase electricity, decide who will supply them, and have this electricity delivered to their homes and businesses. At the same time, the system should assure that suppliers, transmitters, and distributors receive a fair price for their actions. Such a market place puts choice in the hands of the consumer, delivers accurate price (and use) information, and continues the reliability of the system. There are a number of issues embedded in the notion of "full and fair" competition and some of these are discussed below.

A. Functional Unbundling

An initial set of concerns centers on the issue of market power. If market power exits, and it is

exercised, efforts to establish full and fair competition will have been in vain. Market power could be used to arbitrarily increase costs, exclude new entrants, charge high rents in transmission constrained areas, and prevent fair competition between suppliers. This problem should be addressed at the outset and proper mechanisms put in place. The separation of generation, transmission, and distribution ("T&D") is a vital step towards establishing a competitive electric market. If divestiture of generation assets is not achievable, or recommended at this time, the Department should require structural separation of the operation of generation from transmission and distribution assets. While the generation affiliate might not have a separate balance sheet, the Department should take the steps necessary to ensure that no commercially sensitive business information is disclosed to retail affiliates without similar disclosure to all generation competitors. Shared staff, and administrative and general assets are not warranted. A dispute resolution procedure could be created to remedy complaints and restrain the potential for market power.

In establishing unbundled rates for generation and T&D, costs should be properly classified and cross-subsidies between generation and T&D companies should not occur or be reasonably minimized. Finally, unbundling should be performed in accord with the principle of revenue neutrality.

B. Transmission Services

It is our understanding at this time that NEPOOL plus may not be enough to ensure a competitive market and protect against the possibility of market power. Transmission companies should be limited to transmission service, the provision of which should include ancillary services. We expect that FERC will want to review and approve the reasonableness of proposed ancillary services, and we would support the Department's active intervention in any utility and/or

independent system operator filings at FERC.

Once competition ensues, daily transactions should be as observable as possible. Buyers and sellers should have the best information available. As an aside, additional consumer safeguards should be put in place, such as rules for marketers and brokers (suppliers of electricity) which might start with a registration and bonding requirement through the Department.

The rules governing who generates and who does not should be implemented on a non-discriminatory basis. The dispatcher must be independent of the concern about who owns or operates generation and transmission. The dispatcher should be solely responsible for scheduling pool transactions and should have sufficient discretionary powers to impose sanctions or protocols on all sellers to ensure grid stability. Safeguards must be provided so that no single customer or group of customers, or seller or group of sellers can exert market power. The central dispatch should be responsible for providing ancillary services, including pricing the ancillary services under FERC jurisdiction. In this regard, DOER's ISO is on target. To the extent the grid requires reactive power, thereby causing specific units to operate at a loss, it is reasonable to allow for the recoupment of the above market portion in the fees charged by the dispatch for transmission service.

A viable market requires maximizing access to the market by both buyers and sellers. The notion of maximizing access requires the central dispatcher to clear transmission bottlenecks that may isolate consumers from low-cost suppliers. Dispatchers must be free from interference and have a mandate, including financial and operating powers to maximize and optimize buyer and seller access. Assignment of must-run status to units should be reviewed to ensure such status is justified.

C. The Standard Offer

Standard offers should be rationally priced for purposes of serving customers who decide not to participate directly in the generation marketplace. Rational prices should not exceed current rates. The standard offer should be priced in a fashion to simulate the pricing mechanism in an otherwise competitive market. Customers who select the standard offer should enjoy the protection of a rate freeze over the transition period.

The distribution companies should serve as the load aggregator of last resort. The distribution company would be responsible for procuring energy for customers who do not designate a competitive supplier at market prices during the transition period. For customers whose supplier fails to provide 100% of their load requirements, the distribution company should be required to pass through actual costs incurred rather than average market cost. A structure could be developed to discourage end users selecting competitive suppliers from relying on the distribution company to meet peak loads.

Lastly, it may be possible to organize the supply of default generation service through a spot market operator. The spot market operator could act as an intermediary selling power at prices which follow a reasonable benchmark price.

D. Distribution Companies' Role

A.I.M. recognizes the importance of the Commonwealth's utilities and their customers in effectuating socially desirable goals. A.I.M. supports the subsidization of low income customers as presently structured. This special assistance program is "means tested" and provides an invaluable service for those in need.

E. Performance Based Ratemaking

Performance based rates (PBR) should be developed for the distribution companies. Properly designed PBR provides the distribution company with the incentive to minimize its cost of service but not undermine reliability. In structuring the PBR, it is important to remember that the goal of every successful retailer is gratified customers. While numerics about returned phone calls and customer service surveys (customer satisfaction) may distantly relate to quality of service, PBR's should be structured in a way to reasonably assure quality delivery service. Prospects of gamesmanship should be removed.

The price cap approach, as outlined by BECo, is a starting point. The price cap approach assures that the distribution costs will decline in real terms, i.e., increase slower than inflation. However, the price cap approach alone may not provide a distribution company with immediate incentives to cut distribution costs. To encourage further cost savings beyond productivity improvements, the distribution company should be entitled to share in any additional savings by earning a higher return. The ability of a distribution company to earn the higher return should be tied to maintaining high threshold reliability and customers service standards.

F. New Source Performance Standards and New DSM

Some have proposed that existing generation facilities be required to meet the most current environmental standards. A.I.M. does not believe this is necessary to develop a competitive generation market or ensure further progress in achieving air quality. Most existing utility generation boilers in Massachusetts have undergone improvements (and more are expected) per the implementation of the Federal Clean Air Act Amendments. Applying new-source performance standards to existing power generators would be contrary to the primary goal of this

proceeding: lowering electric rates. The additional cost of unnecessary environmental costs could reduce the market value of the facilities and therefore increase stranded costs.

Continuation of DSM programs currently in existence, that are shown to be cost effective, is important. We do not believe, however, utilities should invest in further DSM programs paid for by customers other than the intended beneficiaries. Programs which are economic will be developed by utilities and energy service companies. A.I.M. believes that when customers are free to choose a supplier, they should also be free to choose energy efficiency measures. A.I.M. will participate in future discussions regarding development of renewable technologies. Fuel diversity is important to the Commonwealth's future. It would not be advisable to place all our eggs in the natural gas basket. However, near-term rate relief is a main priority for the business community, and any increase in cost would be difficult to justify.

III. TRANSITION

Notwithstanding what the market should look like and how it should function, it is necessary to get from the current highly regulated world and its current costs to the new system. This transition is critical. It will set some costs in place. It will determine (by the reaction of each stakeholder to it) whether there will be litigation, and therefore, delays in starting "choice" with full and fair competition. The following offers some ideas which we will discuss with all parties.

A. Utility Recovery of Net Non-Mitigable Stranded Costs

As stated in the Department's order, utilities should have a reasonable opportunity to recover net non-mitigable stranded costs. Utilities made investments over many decades with an obligation to serve, and the Department should not impose 20:20 hindsight on the prudence of all generation-related investments and other public policy decisions. On the other hand, the

weakened competitive position of commercial and industrial consumers due to high electricity costs illustrates the economic burdens borne by all Massachusetts consumers. All uneconomic costs should not be borne by ratepayers. The risks and rewards of competition must be shared in some fashion. The Department's principle that the utilities should have a reasonable opportunity to recover net non-mitigable stranded costs should control the ultimate guidelines and mechanisms defined and implemented by the Department.

There is some question about whether the plans adequately provide for a netting of economic and uneconomic assets to mitigate stranded costs. For example, EUA, a company whose resource mix emphasizes nuclear power, excludes certain fossil and hydro plants from the determination of stranded costs, although the market value of those fossil and hydro plants may indeed exceed net book cost. One exception is for Ocean State Power ("OSP"), an independent power producer,[1] in which EUA has an ownership share. OSP's contract price exceeds market value. MECo's proposal raises a similar concern. It seeks to recover all sunk generation costs unless the assets are sold. So long as MECo generation affiliates remain in the generation business, the economic rents obtained through asset appreciation are allocated to the company. For example the Manchester Street plant is a newly reconstructed generating facility which should have some value after the transition period. This value should be netted against other stranded costs in its portfolio. BECo ties its offer of a guaranteed price to full recovery of stranded costs, and has created an index as a proxy for lost load prior to the establishment of a efficient market. A.I.M. is unsure of the accuracy of this index.

In the final analysis netting and mitigation are vital concepts to get from here to a competitive market. We will pursue discussions with the submitters of the plans in this regard.

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[1] Utilities are not legally required under PURPA to enter into long term purchase obligations with IPPs.

In all the plans a utility generation entity retains ownership of the assets, as well as the ongoing ability to sell electricity at market rates once the standard offer expires or customers migrate off-system. The Department should examine the notion of a voluntary phased divestiture over a reasonable transition period, especially if market power exists. The Department might consider incentives that could motivate owners to divest generation resources and credit some of the proceeds to ratepayers through mitigation of stranded costs. Consistent with California utilities' willingness to sell off generation plants and the initial expressions of interest by BECo and Commonwealth Energy, other Massachusetts electrics could be rewarded for following the California lead. The California Commission's proposal to reduce the imputed cost of capital on those generation assets laying claims to transitional support is reasonable. There, the California Commission would lower the return on the undepreciated asset financed by equity to a level 10% below the debt cost is reasonable.[2] Whether or not 10% is enough should be assessed.

B. Dealing with the Past

In the late 1970's and early 1980's, oil prices were forecasted in New England to spiral upward indefinitely, exceeding $100 per barrel before the turn of the century. New nuclear power plants were estimated to cost billions of dollars less than the actual installed cost; and forecasted long term energy benefits proved illusory. Avoided costs projections resulted in contract payments to qualifying facilities ("QFs") under the 1978 Public Utility Regulatory Policies Act ("PURPA") materially above what actual avoided costs have been. Utilities here and elsewhere in the country have had similar experiences, although here there were different responses.

Utility divestiture has been advanced as a means to create market rivals leading to the discovery of

[2] The CPUC decided to allow a 10 basis point increase in equity return for each 10% of fossil plants disposed of through sale or spinoff. Decision 95-12-063 (January 1996), pg. 111.

information about the true level of stranded costs. Notwithstanding how divestiture is decided, A.I.M. urges the Department to ensure the functional separation of generation affiliates is achieved as fully as possible, as quickly as possible. As some utilities have recommended, A.I.M. agrees with the use of trackers or balancing accounts, at least through the transition period, to ensure that customer contributions to utility stranded costs are periodically reconciled with market indices. Application of the trackers should not be restricted to the actual payments to QFs, however. Static, deterministic forecasts of market rates for generation supply are not a good idea and should not become the basis for computing transition surcharges.

C. The Regulatory Compact

Each plan interprets the regulatory compact as entitling recovery of stranded costs. This interpretation may be too broad. It is argued that investors provided financing on the implied promise that prudent investments would be protected from losses. But debt lenders and equity investors are aware of the risk of some disallowance. Utility shareholders earn a rate of return on investment which includes a premium over U.S. government obligations in order to compensate investors for the risk of changes in industry structure. Investors in electric utility stocks have seen other regulated industries, some capital intensive, i.e., rail, trucking, airline, telecommunications, and natural gas undergo significant restructuring.

In short, somewhere in the regulatory compact there is space for the idea that returns are not fixed in time. As Justice Butler opined in *Bluefield Waterworks*, "[A] rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally."[3] In *Hope Natural Gas*, the Supreme Court said

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[3] Bluefield Waterworks & Improvement Co. v. Public Service Commission, 262, U.S. 679, 692-695 (1923).

that "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called 'fair value' rate base."[4] Earlier in *Cedar Rapids*, Justice Holmes commented that commissions need to steer clear of extreme returns, in essence, mediating the bargaining process between investors and ratepayers.[5] The notion of such space is evident in contemporary energy regulation. In restructuring the gas industry, FERC recognized the principle that all segments of the industry -- pipelines, producers, gas utilities, and end users -- contributed to funding the pipeline's take-or-pay costs. In FERC's landmark Order No. 528 the Commission stated that "[n]o single segment of the industry is to blame for the take-or-pay problems and all segments should share in the costs of making the transition to a more competitive market, since all segments are benefiting from the transition."[6] In Order Nos. 500 and 528, FERC ultimately required pipelines to absorb a portion of their stranded costs. The pipelines were permitted to collect as much as 75% of the accrued take-or-pay liabilities, but would be substantially at risk for two-thirds of the amount under the volumetric surcharge. FERC's order allowed the pipelines to collect 50% of the accrued take-or-pay liabilities on a demand basis. Without endorsing any particular formula, methodology or percentages at this time, we would observe that discussions about this aspect of restructuring should continue among all the parties.

D. The Cost of Decisions Must be Shared

Restructuring should permit utilities the opportunity to recover net, non-mitigable stranded costs.

Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

Cedar Rapids Gas Light Co. v. Cedar Rapids, 223 U.S. 655, 699 (1912).

FERC Order No. 528, ¶61,163, issued November 1, 1990.

The netted remaining stranded costs should be allocated equitably among all interests to the maximum extent practicable. There have been mistakes over the years, and these costs should not be paid entirely by customers.

Despite the administrative burden, A.I.M. suggests that the Department could identify utility capital investments and contract obligations on a specific basis, quantify such costs as accurately as possible, and separately identify prudently incurred investments from those that are not.

Long term contracts with QFs, uneconomic investments in demand side management or pollution control technologies, social programs, and property taxes are items that were not initiated by utilities and were believed to be, and some continue to be, beneficial to society. Therefore, investors should not be penalized.

E. Adjusting for Recent Nuclear Plants

The Seabrook and Millstone 3 nuclear plants were originally planned during the early 1970s, a time when it appeared that load growth and rising fossil fuel prices justified the addition of new nuclear baseload capacity. However, conditions changed dramatically in the late 1970s and 1980s. The cost of building new nuclear plants skyrocketed. At the same time, the need for the capacity from the new power plants decreased due to lower forecasts of future utility loads, and the emergence of reliable alternate technologies. By the 1980s, premium fossil fuel prices had collapsed leading other utilities across the U.S. to cancel nuclear plants, many well underway. In total, over $35 billion of nuclear plant investments were abandoned during this period. Substantial investments had been made in some of these units prior to cancellation. Seabrook and Millstone Unit 3 went forward. Nevertheless, these costs should not be put entirely on the companies.

Given the magnitude of the stranded cost burdens associated with Seabrook and Millstone 3, one approach suggested would allow the utilities to recover their stranded nuclear investments over a ten year period *without* earning a return on the unamortized balance. The Department could apply a prudent, used and useful standard to allocate stranded nuclear construction costs and capital additions expenditures between ratepayers and shareholders. Under this standard, each utility would be allowed to recover all prudently incurred nuclear investments, without any return, during the transition period. This treatment would result in a reasonable sharing of the stranded costs between all interests.

An alternate approach the Department might consider, would be to impute a much lower cost of capital to reflect the diminution in risk once the nuclear related stranded cost is certified for transition cost recovery. Consistent with California's standard, setting the equity portion of the net book value at a level no higher than 90% of the embedded cost of debt would produce a reasonable rate of return on equity. A commensurate reduction in debt cost would also be equitable.

F. Treatment of Nuclear Related Stranded Costs

Investments in nuclear assets other than Seabrook and Millstone 3 appear to constitute legitimate stranded costs, and should be eligible for full recovery. For holding companies, the Department should examine the reasonableness of the allocation factor to Massachusetts distribution companies. While prior expenditures should be deemed eligible for cost recovery, future capital expenditures related to continued operation of these nuclear units might not be deemed stranded. Owners should be responsible for the recovery of non-decommissioning related costs during both the transition period and thereafter.

NRC decommissioning costs must be recovered in full and should remain the responsibility of the

distribution company. Issues of intergenerational equity arise, however.[7] There are a number of concerns that the Department should consider during the transition period. First, safeguards should be established to assure adequate funds to decommission the nuclear plants at the end of their service lives; current ratepayers should not fund all decommissioning costs during the transition period. It is not equitable to require this generation of ratepayers to bear all decommissioning costs. Instead, the local distribution company should be required to collect decommissioning costs from future customers.

Second, BECo has proposed that all future property taxes be included as decommissioning costs. The Department should mandate a reasonable period for adjustment regarding property tax payments over the transition period to reflect the market valuation of nuclear and non-nuclear assets.

Third, BECo and EUA have also proposed recovery of all nuclear Operations & Maintenance (O&M) expenses that are "independent of operation" as part of the transition charge. According to the utilities, certain costs continue to be incurred regardless of whether the nuclear units operate in order to maintain a safe condition until the commencement of decommissioning. Prior to authorizing inclusion for transition surcharges, the Department should on a case-by-case basis ensure that these cost are related solely to decommissioning.

MECo has proposed that its liability to the Yankee Atomic Electric Company related to the 1992 shutdown of the Yankee Rowe nuclear plant be included in the transition charge. We believe this is important. To get on with restructuring, we need to "close the book." On the other hand, WMECo has proposed to recover the funds which remain in the "amortization of deferred nuclear outage

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At the outset of retail choice in January 1998, current ratepayers will have received power from Millstone Unit 3 for less than one-third of the unit's projected 40 year service life. From Seabrook, ratepayers will have received power for less than one-fifth of that unit's projected service life.

costs" account as of the onset of retail choice. WMECO should recover such costs to the extent the outage contingencies were reasonable in the first place.

G. Mitigation of Stranded Costs

In quantifying stranded costs, the sunk cost of utility generation must be offset by the market value. Since market value is not known, a sale, valuation or appraisal must be performed. Given the reasonableness of the Department's principle that total stranded costs represent net, non-Mitigable costs, any framework for valuing stranded costs must bring *all* generation assets to market value. The degree to which investment is stranded should be gauged around the difference between market value and net book cost. For various reasons, the notion of pegging stranded costs to the difference between market value and forecasted revenue requirements may not suffice.

Though we are aware that divestiture may not be practical at this time and we do not endorse it at this time, it may be in the long run the most efficient and equitable way to proceed. The Department should look at this closely. There are risks to consumers related to auctions and mandatory spin-offs, but the risks are reduced by timing the sales of the generation function over a number of years. Market valuation of nuclear assets must reflect decommissioning liabilities remaining with the distribution companies. If the asset is not sold, an objective appraisal simulating what an arms-length purchaser would pay is a second-best approach. Such a methodology could ease the barriers to entry in the generation market and aid in the establishment of a workable competitive electric market.

With any market valuation methodology, the risk exists for the plant to be valued below its true market value. Both owner and consumer interests could be thwarted if spin-offs of generation assets happen too quickly and the financial market is either saturated or impaired by high interest rates, or

both. To mitigate the downward pressure on transaction costs attributable to so-called "fire-sales," the Department could take measures to ensure that the capital markets can be expected to absorb the phased sell off of certain generation assets.[8] To the extent utility sellers realize less than net book value from the sale the plant and the asset ultimately appreciates in value, ratepayers are harmed, but not necessarily more than would otherwise be the case absent the spin-down or sell off of generation assets. Concerns over liquidation prices should not prevent the use of a market valuation approach. The prospect of ratepayers paying once through a transition surcharge and again through the subsequent market price exposes consumers to a potential loss, but this exposure does not undermine the efficacy of a market valuation approach. It is the acquiring entity who accepts the risk that the asset may be overvalued in exchange for the right to earn an unregulated return over the remaining asset life.

Amortization of stranded costs should reflect a lower return on equity ("ROE") than that currently authorized because of the reduced risk that the stranded costs would have been uncollected under a continuation of rate base regulation. MECo appears to have endorsed this idea, but there are questions regarding certain mechanics used to determine the lower ROE. The divestiture issue, valuation, and rate of return are areas where we will explicitly attempt to continue discussion with interested parties, recognizing that our comments are initial.

Utilities should be encouraged to undertake efforts with PURPA based QF projects to buy-out or reform the contracts. Whether or not voluntary utility commitments with IPPs should be deemed eligible for stranded cost recovery should be decided on a fact specific basis. There is support for the notion that utilities be permitted to retain up to 10% of the savings arising from QF contract

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The AT&T divestiture, the spin-off of Pacific Telesis of its wireless operations, and the floatation of the twelve area boards in the United Kingdom all exemplify successful asset separations despite fears in the financial markets that distress prices would occur.

restructuring. The remaining savings would accrue to the consumers through reduced fixed or variable transition charges. Similarly, the determination of stranded costs must account for deferred taxes.

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A.I.M. appreciates the opportunity to file these initial comments, and we look forward to working with you and all interested parties in the future.

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